Internal Revenue Service

memorandum

CC:TL
Br3:WEWilliams

date: 4 FEB 1986

to: District Counsel, Hartford CC:HAR

from: Acting Director, Tax Litigation Division CC:TL

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subject: [redacted] Tax District and [redacted]
Your ref: CC:HAR-TL ARCeccherini

This responds to your memorandum dated January 10, 1986, in which you request technical advice concerning an issue that is likely to arise as a result of the audit of the income tax returns of owners of realty in the [redacted] community.

Issue:

Whether amounts paid by condominium unit owners to a tax district created for the operation and maintenance of the common areas of the condominium homeowners association are deductible as real property taxes paid to a political subdivision under the provisions of I.R.C. § 164, when carried out under Connecticut's tax district enabling statute. 0164.19-01.

Conclusion:

It is our view that the amounts paid by property owners to the [redacted] Tax District do not meet the definition of "real property taxes" in sections 1.164-3(b) and 1.164-4(a) of the Treasury Regulations. These amounts are not imposed and collected for the purpose of raising revenues to be used for public or governmental purposes but are rather for the exclusive purpose of benefiting the property owners in the district. The amounts are essentially user fees for particular services and facilities the benefit of which is restricted to the owners of the property upon which the amounts are levied.

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Discussion:

I.R.C. § 164(a)(1) allows a taxpayer to deduct state and local, and foreign, real property taxes in the taxable year within which paid or accrued. Section 164(c)(1) denies a deduction for taxes assessed against local benefits of a kind tending to increase the value of the property assessed. However, to disallow a deduction under section 164(c)(1), the Service is not required to establish that the taxpayer's property actually increased in value as a result of the benefit conferred on the property. Caldwell Mining Co. v. Commissioner, 3 B.T.A. 1232 (1926); and Noble v. Commissioner, 70 T.C. 916 (1978). Section 1.164-4(a) of the Regulations defines "local benefits" as

> assessments, paid for local benefits such as street sidewalks, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied .... A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction.

Section 1.164-3(b) of the Regulations defines the term "real property taxes" as taxes imposed on interests in real property and levied for the general public welfare, not including taxes assessed against local benefits. Whether a levy is a tax within the meaning of federal law, including section 164, is determined by principles developed under federal law, not state or foreign law characterizations. See Rev. Rul. 76-215, 1976-1 C.B. 194; and Lyeth v. Hoey, 305 U.S. 188 (1938), 1938-2 C.B. 208.

Under federal law, a tax is an enforced contribution, exacted pursuant to legislative authority in the exercise of the taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes, and not as a payment for some special privilege granted or service rendered. Rev. Rul. 77-29, 1977-1 C.B. 44 (annual fees earmarked for sanitation services, imposed on all residential and commercial property in a county, based on the assessed value of the property,

are not deductible as real property taxes); compare Rev. Rul. 71-49, 1971-1 C.B. 103 (tax equivalency payments made to the N.Y. City Educational Construction Fund by a cooperative housing corporation are deductible real property taxes, because the payments are "designated for a public purpose rather than for some privilege, service, or regulatory function, or for some other local benefit tending to increase the value of the property upon which the payments are made"). The name given to a particular charge is inconsequential in the determination of whether a charge qualifies as a "tax" within the meaning of section 164 or its predecessors. Holeproof Hosiery Co. v. Commissioner, 11 B.T.A. 547, 553 (1928); Rev. Rul. 58-141, 1958-1 C.B. 101; Rev. Rul. 61-152, 1961-2 C.B. 42; and Rev. Rul. 71-49, supra.

Rev. Rul. 61-152 defines the term "tax" as including every burden that may lawfully be laid upon the citizen by virtue of the taxing power, but its application in statutory provisions varies with the intent and purpose of the particular provision. A tax, as previously noted, is not a payment for some special privilege granted or service rendered. In view of such distinctions, the question of whether a particular charge is to be regarded as a tax depends upon its real nature. If it is in the nature of a tax, it is not material that it may be called by a different name; conversely, if it is not in the nature of a tax, it is not material that it may be so called.

The Service, in Rev. Rul. 73-600, 1973-2 C.B. 47, and Rev. Rul. 75-558, 1975-2 C.B. 67, has set forth several of the characteristics of a real property tax deductible under section 164. These characteristics include: (1) the tax is generally imposed on, or triggered by, the ownership of real property and not imposed on, or triggered by, a single incident of, or interest in, real property ownership such as use or occupancy; (2) the tax is measured by the value of the real property; and (3) liability for the tax is not solely personal.

Examples of payments for local benefits that have been held to be nondeductible under section 164 include front foot assessments for water main and sewer improvements (Rev. Rul. 75-455, 1975-2 C.B. 68); assessments for sidewalk construction (Rose v. Commissioner, T.C. Memo. 1972-39); payments made to extinguish the taxpayer's liability on a special improvement bond to the extent that the taxpayer does not establish that the payment is not attributable to interest accrued on the bond indebtedness (Harris v. Commissioner, T.C. Memo. 1980-56, aff'd by

unpublished order (9th Cir. 1982); and a special assessment for construction of a sewage treatment plant (Wilson v. Commissioner, T.C. Memo. 1963-188, aff'd 340 F.2d 609 (5th Cir. 1965).

Rev. Rul. 77-164, 1977-1 C.B. 20, concerns a community development authority created under state law, that was empowered to impose, collect, and receive service and user fees to be used for the construction, operation, and maintenance of community buildings, recreation facilities, streets, lighting, and other capital improvements that benefit the property owners. In concluding that the fees are not real property taxes within the meaning of section 164, the ruling states that the authority's power to impose and collect service and user fees is not analogous to the power to tax; the fees are not imposed and collected for the purpose of raising revenues to be used for public or governmental purposes but instead are raised for the purpose of benefiting the property owners of one community.

Section 7-324 of the Connecticut General Statutes provides that a "district" means any fire district, sewer district, fire and sewer district, lighting district, village, beach or improvement association and any other district or association, except a school district, wholly within a town and having the power to make appropriations or to levy taxes.

Section 7-326 of the Connecticut General Statutes provides the purposes for which a district may be established. They are as follows: to extinguish fires, to light streets, to plant and care for shade and ornamental trees, to construct and maintain roads, sidewalks, crosswalks, drains and sewers, to appoint and employ watchmen or police officers, to construct, maintain and regulate the use of recreational facilities, to plan, lay out, acquire, construct, repair, maintain, supervise and manage a flood or erosion control system, to plan, lay out, acquire, construct, maintain, operate and regulate the use of a community water system, to collect garbage, ashes and all other refuse matter in any portion of such district and provide for the disposal of such matter, to establish a zoning commission and a zoning board of appeals or a planning commission, or both, and to adopt building regulations.

Section 7-325 of the Connecticut General Statutes provides that upon the petition of twenty or more voters of any town, not residing within the territorial limits of any city or borough in such town, specifying the limits of a proposed district for any or all of the purposes set forth in section 7-325, a meeting of

voters residing within the specified limits is called to act upon the petition. Upon approval of the petition by the meeting, the district becomes a body corporate and politic and has the powers, not inconsistent with the general statutes, in relation to the objects for which it was established, that are necessary for the accomplishment of such objects, including the powers to lay and collect taxes. The name of the district and a description of its territorial limits and of any additions that may be made thereto are then recorded in the land records of the town in which the district is located.

Section 7-328 of the Connecticut General Statutes provides that the territorial limits of the district constitute a separate taxing district. When the district meeting has fixed the tax rate, a rate bill is prepared, apportioning to each owner of property the owner's proportionate share of the taxes. Subject to the provisions of the general statutes, the district may issue bonds and the board of directors may pledge the credit of the district for any money borrowed for the construction of any public works authorized by sections 7-324 and 7-329.

In this case, the [redacted] Tax District was established pursuant to section 7-324 of the Connecticut General Statutes by the requisite number of lot owners in [redacted], a residential community located [redacted] Conn. The [redacted] Tax District adopted a [redacted] authorizing it to perform all functions and activities enumerated in the sections of the Connecticut General Statutes described above. The amounts levied and collected by the Tax District from [redacted] property owners are used for the maintenance and operation of the common areas within the subdivision including the building and maintenance of streets, sidewalks and sewers, landscaping, recreational facilities [redacted], and the employment of a security force that patrols the roads and restricts access to the community to lot owners, their guests and invitees. All of these functions were performed by the [redacted] prior to the formation of the Tax District in [redacted].

Clearly, maximizing the individual lot owner's federal real property tax deduction was a primary consideration in forming the [redacted] Tax District. The [redacted] was advised by its Tax District Committee in a letter dated [redacted] that

> it would appear that it would be beneficial to the individual homeowners to form a Special Tax District for [redacted] in that a very substantial portion of

the monthly maintenance charge (perhaps in excess of [redacted] percent) will be tax deductible from the individual homeowners Federal income tax.

In addition, our preliminary investigation shows that this can be accomplished while still maintaining the character and quality of the [redacted] community. The formation of the Tax District does not require that we make the roads or common facilities of [redacted] available to the general public or other residents of the City of [redacted].

The fact that the State of Connecticut permits the establishment of fire, sewer, or other districts, having the power to lay and collect taxes, does not establish that those payments are in fact real property tax payments, because the focus is on the nature of the transaction under federal law. See Lyeth v. Hoey, 205 U.S. 188 (1938), 1938-2 C.B. 208; and Rev. Rul. 79-180, 1979-1 C.B. 95.

Like the fees in Rev. Rul. 77-164, the amounts assessed by the Tax District in this case are not imposed and collected for the purpose of raising revenues to be used for public or governmental purposes but are for the purpose of benefiting the property owners in the district. The services provided by the district are the same services that the [redacted] homeowners association previously provided from condominium fees paid to the association by the homeowners. The homeowners receive the same services that they received before the district was established. The only difference is that certain services previously furnished by the association are now furnished by the tax district. In substance, therefore, the establishment of the tax district is merely an attempt by the homeowners to convert a portion of an otherwise nondeductible homeowners association condominium fee into a deductible tax. On these facts, we do not believe that the tax district assessments meet the definition of "real property taxes" in sections 1.164-3(b) and 1.164-4(a) of the Regulations, which require that taxes be levied for the general public welfare.

The legal counsel to the committee appointed by the [redacted] to advise the [redacted] on the organization of a tax district relied on Rev. Rul. 74-52, 1974-1 C.B. 50, in concluding that payments to the tax district would be deductible under section 164. The ruling holds that an increase in taxes on all

property within a municipality for the cost of paying bonds that were sold by the municipality for the construction of a sewage disposal system is deductible as a tax under section 164. Importantly, the municipality incorporated the cost of paying the bonds into its general budget rather than imposing a user fee or special assessment against the particular realty that was to benefit. The ruling concludes that the tax increase is not related to the benefits received by land owners but rather is levied for the general welfare.

It is our view that the fees levied and collected by the [redacted] Tax District are distinguishable from the taxes held to be deductible in Rev. Rul. 74-52. The amounts levied by the [redacted] Tax District are essentially user fees that entitle a property owner to use and benefit from the facilities and services provided and maintained by the Tax District; use of the facilities and improvements by persons not paying the fees is prohibited. We think that the Tax District fees are clearly for local benefits of the type contemplated by section 164(c)(1).

Accordingly, we recommend that the Service move to disallow the deductions claimed by the [redacted] lot owners for payments of assessments to the [redacted] Tax District.

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